JANUARY 2010

Outlook on Global Equity Markets

The risks to the global financial system subsided over the past year due to the unprecedented monetary actions taken by major central banks; a recent flow of positive economic data indicated continued improvement in the underlying fundamentals of the global economy. This, in turn, encouraged investors to buy into riskier assets. In the final quarter of 2009, equities in the United States outpaced many global peers amid renewed confidence in its economy. The U.S. economy appears to be pulling out of its recession, as it returned to growth following four consecutive quarters of contraction. The housing market also showed further signs of stabilization, as the U.S. Government extended its tax incentive program and maintained low borrowing costs for homebuyers. However, the recovery in consumer activity, a primary driver of the economy in the United States, remained uncertain amid the high unemployment rate. A deceleration of consumer credit volumes also pointed to the continued deleveraging of U.S. consumers. European stocks were mixed amid increasing divergence within the Eurozone economy. The downgrade of Greece's credit rating during the quarter also rekindled fear over sovereign risks. In Asia, Japan continued to underperform its regional peers, although it appeared to regain some positive momentum in December amid easing concerns over its strong currency. Shares in emerging markets experienced another upward move in the fourth quarter to end a remarkably strong year. By sector, materials performed strongly for the quarter on the back of an improving economic outlook. Strong commodity prices boosted confidence in many commodity producers. The information technology sector performed well amid optimism that technology spending was improving. The health care sector also performed well, particularly in the United States, due to easing concerns over U.S. health care reform. A pick-up in mergers and acquisitions activity added confidence to the sector as well. Meanwhile, the financials sector was the worst performer amid fresh concerns about the asset quality of large banks. The utilities sector also underperformed during the period. In the currency markets, the U.S. dollar rebounded against major currencies after an extended period of weakness. Investors' sentiment toward the U.S. dollar appeared to be changing amid improving U.S. economic data, which led to speculation that the U.S. Federal Reserve (the Fed) may raise interest rates sooner than expected.

U.S. EQUITY

Examining an Evolving Economy

The events of 2009 have largely eliminated the short-term risk of systemic failure that we faced only a year ago. The adage of not fighting the Fed has clearly proven correct to date, as a near-zero interest rate policy, combined with a fiscal deficit equal to 10% of U.S. GDP, have transformed economic freefall to moderate growth quite quickly. The Fed and the U.S. Treasury Department bought over $1.25 trillion of Agency mortgage-backed securities (MBS)[1] to drive mortgage rates in the United States down by 200 basis points from the highs of the mid-2008 to mid-2009 period.[2] The lower cost of borrowing reduced monthly payments by 20% per dollar of debt, leading house prices to stabilize and even increase by just over 5% from the lows, as measured by the S&P Case-Shiller 20 City Home Price Index (seasonally unadjusted). Savings rates in the United States rose from just above zero to almost 5% by the end of 2009.[3] Leverage began to decrease across the private sector even while government debt/GDP grew. Against this backdrop, equity markets recovered almost exactly half of the ground lost during the prior panic, while credit spreads narrowed to levels inside long-term averages.

Looking forward, we believe it is important to recognize that the degree of economic healing that many think has occurred is exaggerated by the remedies that have been applied by a range of government entities. In our view, before the economy will be healthy enough to sustain material longer-term growth, the United States will need to deleverage substantially. In the second and third quarters of 2009, debt outstanding in the United States fell from 362% of GDP to 355%, in spite of an increase of 560 basis points in government debt/GDP.[4] Even after this six-month decline, consumer and financial sector debt levels are literally multiples of levels experienced in prior generations. Given that we have exited the era of disinflation, in which interest rates declined for over 20 years, the potential for lower borrowing rates to sustain current levels of leverage (or even higher levels) is de minimis. As a result, we anticipate a multi-year, if not multi-decade, process in which the U.S. economy deleverages and recalibrates to a more sustainable composition. Moreover, recognizing that risk often merely changes form rather than disappears, we believe the key factors to watch have changed substantially as we enter the New Year.

As we indicated in the 2009 Q4 Outlook, it should be clear that no trend is a straight line. Rather, we expect to see intermittent periods, such as the third quarter of 2009, in which risk is embraced in the hope that cash flow will follow.[5] However, we believe that, for many companies, the cash flow will not come. Our investment focus is unchanged: We continue to invest in companies with robust organic cash flow, strong balance sheets, and the operational flexibility that results from these factors. To capitalize on the opportunities that lie ahead, we employ forward-looking, fundamental research that recognizes what can and cannot be estimated with precision and values companies under key scenarios related to these drivers.

THE QUARTER BEHIND US

After enjoying five successive months of gains, house prices stalled in October. Credit spreads continued to narrow, but the U.S. Treasury yield curve steepened substantially. The process of unwinding extraordinary government intervention in some markets also began this quarter.

- House prices rose. Seasonally unadjusted home prices were up, as we expected, with the final reading delivered by Standard & Poor's on December 29 showing an increase for the period from August through October of 1.6%, a clear deceleration from the 3.6% gain from May to July. As we have noted before, we believe that lower mortgage rates, combined with foreclosure mitigation efforts and seasonality, drove the gain.

- Credit markets continued to recover, but the Treasury yield curve steepened. U.S. commercial mortgage-backed securities (CMBS) originations began again in the quarter with just under $1.4 billion of new issuance. Full-year issuance totaled $2.2 billion versus $12.1 billion in 2008 and $230.2 billion in 2007.[6] Clearly the market has not healed, but this is a start.

  The spread of the Moody's Baa Corporate Credit Index over 10-year Treasurys narrowed 36 basis points in the quarter to 252 basis points. The yield on the Index, however, increased from 6.17% to 6.36%, as Treasury yields rose from 3.31% to 3.84%.[7]

  The steepness of the Treasury yield curve rose substantially, as markets increasingly priced in lower Fed Funds rates for a longer period while also pricing in a higher long-term risk of inflation, which is effectively another form of sovereign default. The spread between 2-year and 10-year Treasurys rose from 236 basis points at the start of the quarter to a multi-decade high of 285 basis points near the end of December, before falling back to 270 basis points.

- The unwinding process began. The Fed stopped buying Treasurys in October after accumulating just under $270 billion of such securities.[8] While it is impossible to ascribe the precise degree to which Treasury yields increased because of the cessation of purchases, it is clear that it could have been a contributing factor.

  The Treasury Department stopped buying Agency MBS in December, after purchasing approximately $220 billion of such debt since taking Fannie Mae and Freddie Mac into conservatorship in September 2008. The Treasury

Department simultaneously removed the $200 billion per-company limit on how much capital it could contribute to Fannie and Freddie.

Last, but by no means least, the largest banks that had received funds from the U.S. Government through the Capital Purchase Program (CPP) repaid over $120 billion to the Government, not including $4 billion of proceeds from the sale of warrants awarded to the Treasury Department alongside the capital injections. The banks exited the CPP with much higher common equity capital ratios, with Bank of America, Wells Fargo, and Citigroup raising over $45 billion during a two-week period in December.

THE QUARTER AND YEAR AHEAD OF US

There is no doubt that the actions taken since the collapse of Lehman Brothers have brought us to a much better place in terms of GDP than critics give credit for or even the most ardent optimists would have thought possible a year ago. We have recently begun to see broadening signs of economic stabilization. Indicators ranging from the U.S. Institute for Supply Management (ISM) survey to recent figures for temporary employment seem to augur, at minimum, stabilization, if not a return to economic and employment growth. That said, our key considerations regarding the United States going into 2010 are:

- The extension of the Fed's MBS purchase program is pivotal. The single most important decision we anticipate is whether the Fed will extend and expand the MBS purchase program beyond the previously extended 31 March 2010 expiration date and the original $1.25 trillion size. We see it as pivotal that the Fed extends this program and purchases additional securities, as the housing market remains far too fragile to stand on its own. Importantly, if the Fed were to stop buying MBS as announced, we believe mortgage rates could rise by as much as 100 basis points, increasing the monthly payments for new borrowers by over 11% per dollar of debt. Such an increase would aggravate the decline in house prices that we expect even with sustained Fed purchases. Our expectation is that the Fed will announce its decision in its Federal Open Market Committee (FOMC) statement to be released on January 27.

- House prices continue to be weak. We expect house prices to decline through the first quarter and much of the year, as interest rate tailwinds have disappeared, even with Fed support for the market. We also see seasonality at work, as demand for homes tends to decline in the fall and winter months. Historically, supply would decline as well, as sellers would wait for seasonal strength to put their homes on the market. The problem now is that the houses hitting the market are, in many cases, distressed sales of foreclosed homes.

- Fiscal stimulus increases in importance. As we noted in our last quarterly outlook, fiscal stimulus becomes even more prominent in 2010 per the original legislated plan. As of 25 December 2009, $253 billion of the $787 billion of fiscal stimulus had been delivered to the economy through either tax cuts or spending programs. This amount is higher than the originally planned $185 billion for 2009; clearly, it accelerated substantially in the fourth quarter. The planned spending increases and tax reductions for 2010 were originally set at just under $400 billion, implying a 100 basis point incremental boost to GDP versus the stimulus in 2009. Potentially offsetting more than half of this stimulus will be the impact of reductions in state and local government spending.

- The removal of uncertainty about health care reform may be a positive factor. While perhaps no one is completely happy with the current proposals for health care reform, we are likely to see some closure on this issue in the first quarter. The removal of uncertainty in itself may well be a positive to watch, especially as investors see the final legislation and assess its implications for a wide range of companies in and beyond the health care sector. That said, it is clear to us that the current plans being discussed in Washington on all sides fail to bend the cost curve in any meaningful way. At best, the legislation will not increase deficits in the future. As such, even when this legislation is finalized, which we view as very probable, we are likely to be revisiting the topic for years to come.

- M&A activity will pick up. We believe M&A activity levels will increase throughout the year ahead. The longer interest rates remain at current, historically low levels on an absolute basis, the more M&A activity we expect to see.

Even with the equity market rally in 2009, accretive acquisitions can be accomplished in a wide range of industries. We believe that one side effect of the differentiation in performance, which we expect between companies with strong balance sheets, robust organic cash flows, and operational flexibility and their peers, will be an increase in the number of strategic sellers. These sellers would be CEOs who, recognizing that their ability to deliver the cash flow shareholders expect is impaired, will try to maximize value by selling. As buyers, the strong companies will likely be better positioned than they were in the past, with cash on hand and the ability to borrow money at low, tax-deductible interest rates.

Through 2010 and beyond, the secular trends we see as most important are:

- Deleveraging will continue. As discussed above, we believe we are at the beginning of a multi-year period during which debt levels relative to GDP will decline. We have only just begun this process and will watch both the absolute ratio of total debt to GDP as well as the composition. Clearly, the socialization of debt and risk entails certain perils—foremost among them, the fact that the risk-free curve increasingly represents the aggregated risk of the private-sector constituents. Put another way, the term "risk-free rate" will become decreasingly relevant, as U.S. sovereign debt becomes riskier from a credit perspective and from the perspective of heightened risk of inflation—as politicians may be tempted to devalue the debt.

- Savings rate will rise. The flipside of the deleveraging story is that of savings. Even though equity returns for investors have been negative for the last decade, and short-term interest rates are effectively at zero, Americans continue to save well below historical levels relative to their disposable personal income. Even with the recent increase to about 5%, savings rates remain well below the 7% to 13% we have observed historically.[9] While Americans have been a characteristically optimistic people in the past, retirement requires more than enthusiasm. It requires cash. Given the growing fiscal debt and contingent liabilities facing the U.S. Government, we believe consumers will be forced to save at substantially higher levels. This will not happen overnight, but will instead be a multi-year/decade phenomenon as well.

- The composition of U.S. economic activity will recalibrate. One of the biggest opportunities, from a secular perspective, will be in assessing the shifts that will occur in the U.S. economy, and the timing thereof. Put simply, the representation of the financial industry has already declined and is unlikely to reach prior peaks again for decades. We believe certain aspects of the consumer discretionary sector will change substantially, as will the energy and technology sectors. We are sustaining our history of innovative research as it relates to these and other topics to ensure our scenario analysis around each company and sector fully incorporates opportunities, as well as risks.

- Inflation/deflation risk will heighten. In the past, we have made clear our base case view that inflation is unlikely to be a major problem for several years. We also see substantial deflationary pressure in the intermediate term from deleveraging and the associated decreases in consumption to fund higher savings rates. Beyond these economic factors, at some point the U.S. Government will have to wind down its stimulus programs, creating another deflationary force through some combination of decreased government spending and increased taxation, both of which equate to less consumption of goods and services. Beyond these topics, however, we are keenly aware of the risk of longer-term inflation and, importantly, of market perceptions regarding such risk. This past quarter, we had a small taste of what can happen to the sovereign yield curve. This is only a taste so far, but one that could become quite bitter.

- Sociopolitical pressure will increase. A confluence of events is likely to lead to increasing sociopolitical pressure in the United States. Approximately 29% of Americans over the age of 25 have earned a college degree or reached a higher level of education.[10] These individuals experienced an unemployment rate of 4.9% as of November 2009, versus less than 2% only three years earlier.[11] The other 71% of the country, however, is enduring a much more elevated level—in the range from 9% to 17.2%—and duration of joblessness. We do not expect this divergence to end anytime soon, particularly considering that the recalibration of capital flows and economic activity in the United States will put significant pressure on industries requiring less-skilled labor to reduce costs relative to overseas competitors. This topic has no obvious punch line, but could have ramifications for taxes, inflation, and a wide range of policy debates.

CONCLUSION

While conditions for investors have continued to improve through the most recent quarter and for 2009 overall, we believe we will see new forms of opportunity and uncertainty in the quarters and years ahead. This environment demands that managers rely on forward-looking, fundamental research to make investment decisions. As the economy deleverages and recalibrates, we believe our investment focus on balance sheet strength, robust organic cash flows, and the resulting operational flexibility will continue to deliver strong results.

Written by:
Ronald Temple, Managing Director, Portfolio Manager/Analyst

EUROPEAN EQUITY

An Increasingly Stock-specific Market

Europe's largest economies, having managed to insulate themselves from the worst of the global recession, have been the standout performers in the Western world. Germany, France, The Netherlands, and—to a lesser extent—Scandinavia have shown greater resilience through this cycle, particularly at the consumer level. Unemployment has remained relatively stable in many of these countries, while it has almost doubled in the United States and risen steeply elsewhere. Extreme monetary policy measures were not required, interest rates remained higher than most, and there were relatively constrained budget deficit increases. This leaves Continental Europe with less to do to normalize monetary policy; therefore, we believe it is well placed to grow as we move into the post-recession recovery through 2010.

During the second and third quarters of 2009, the market saw one of the strongest rallies in the shortest period of time ever recorded. The market rotated toward the most cyclically sensitive companies earlier than in past cycles. Previously, cyclical stocks commenced their recovery when the economy had moved out of recession; in this cycle they bounced at the first signs of recovery. History shows that high-returning companies ultimately outperform the wider market; in the fourth quarter, this trend was beginning to re-emerge, particularly so in December, as the market became more focused on fundamentals.

Going forward, we believe we will see a much greater divergence between companies within sectors and across markets and regions. Valuations have risen and now need to be justified by profit recovery and growth. We believe the European equity markets will more clearly identify which companies will become "winners" and "losers" at this stage of the cycle.

Europe's healthier economic position is now being recognized by investors, as evidenced by the widening gap in government bond yields between Europe and much of the rest of the developed world. As a result, European businesses will likely be able to refinance more easily and at lower rates than their international competitors, and the European consumer will likely continue to be supported by lower mortgage rates.

Weakness in the peripheral European economies is still of concern to financial markets, as they continue to show signs of distress with spiraling public debt, high unemployment, and property markets that are under pressure. However, in our view, the bad news has already been realized in many of these countries, and further significant shocks that could derail a whole market now appear to be unlikely.

Overall, we remain constructive for European equities. The level of exposure of the large institutional investors to European equities remains near historically low levels. We anticipate that large pools of institutional capital, many of which had sought the sanctuary of cash and bonds during the worst of the market turmoil, will increasingly be directed towards equities. Consequently, in combination with the currently solid macroeconomic position in the larger European countries, we believe the momentum in equity markets will be sustained.

We are finding value and quality across the breadth of the market, in both cyclical and defensive companies. We are overweight pharmaceutical stocks for their currently strong cash-generative earnings and attractive valuations while, on the other hand, we increased our underweight position in utilities as the overcapacity in power generation constrains energy prices in the sector.

Our bottom-up approach to stock selection is finding attractive investment opportunities in Germany, which is our biggest overweight position. We believe some of its big exporters will benefit from the improving global outlook. Conversely, we are struggling to find attractive companies in Italy and Spain, where the economic situation continues to weigh on equity markets, and hence we are underweight these countries.

We believe the market will become much more stock-specific in 2010. We also believe we will see the end of the largely indiscriminate sector rotation that dominated in 2009 and more emphasis on finding strong companies across the full range of sectors. In our view, there remains a great deal of value to be found, particularly amongst higher-quality stocks. Although improving still, the corporate environment remains challenging, and some investors are likely to be disappointed with overly strong revenue projections that are not achieved by some companies. Therefore, we stress the importance of investing in companies with cash-generative, sustainable, and transparent business models, at the right valuation.

Written by:
Aaron Barnfather, Director, Portfolio Manager/Analyst

JAPANESE EQUITY

Not That Bad

Uniquely among major bourses, Japan has been very disappointing, on the downside, during recent months. Concerns over a strong yen, political uncertainty, mixed economic data, and corporate equity issuance have conspired to cast a pall on investor sentiment. This has been compounded by the ease with which Japan "experts" out of Southeast Asia have been playing double-barreled ETFs to position themselves on the bear side of the trade. Given the woeful level of domestic participation, overseas investors have become the swing factor in determining market momentum, and their sentiment is decidedly on the downside. The amount of commentary about the increasing irrelevance of Japan to the world in either a stock-market or economic sense has hit a new high—and it is the rising shrillness of this commentary that gives us cause at long last for optimism.

This is not merely a contrarian market call. We believe there are solid fundamental reasons to begin to look more optimistically at the outlook for Japan. First, its economy is not that bad. The housing market looks like it has finally hit a bottom, with sales recovering and inventories low. Auto sales have been rising by double-digits in recent months. General consumption is also positive, albeit in nominal terms. The export sector has turned up, following the complete collapse at the end of 2008. Unemployment is at 5.5% and has been falling. The credit cycle is finally supportive. Unlike most of the United States and Europe, Japan has dealt with its asset deflation-related credit problems. Banks are seeing little uptick in credit costs, even with the problems that have emerged elsewhere, and have money to lend.

With the decline in the market, valuations are now back to levels not seen since the 2003 lows. Despite this, earnings, cash flow, and balance sheets have improved considerably. While much of the rest of the world has priced in a nicely "V"-shaped recovery, Japan seems to be expecting an "L," or perhaps even worse. Japan is now the only major world market that has adequately priced in the risk of economic disappointment.

Sure, there are some problems. Deflation remains, but it is of the generalized sort, not the insidious debt deflation being experienced elsewhere. One of the unique benefits of generalized price deflation—provided employment stays healthy—is that it leads to vastly improved standards of living. This is exactly what has occurred in Japan. Housing costs are down, affordability is up and per-capita living space is up. Commute times are down. The already hyper-efficient train system is

even more comfortable and flexible. General infrastructure expenditure means the roads, railroads, and airports work well. The variety and availability of food, clothing, and consumable goods have never been higher. It is worth asking whether the mere mention of deflation truly warrants the waves of worry among economists when the tangible benefit to individuals appears so high.

Japan's government does have a debt problem. However, it is self-funding, as Japan is a large creditor nation. As long as the average citizen is willing to fund the current government, it matters little what external rating agencies or sell-side strategists think about the problem.

As for the demographic issues of an aging society, it appears the government is sincere in its efforts to pursue both higher domestic family formation, and a greater integration with Asia to mitigate this issue. Since demographic trends move at a glacial pace, it is only through time that we will be able to ascertain whether the planned initiatives will have any impact.

In the meantime, the global trends away from mass consumerism and towards more investments in infrastructure and care for the environment are unquestionably positive for Japan. In both areas, Japanese companies truly have world-class technology and solutions, and should benefit from demand growth around the globe.

In sum, the fact that the second-largest economy in the world has been thrown into the dustbin of irrelevancy well before its time gives us the first cause for optimism on the outlook for the Japanese market in many years. We believe there is ample economic evidence and valuation support to justify such an outlook, and make 2010 a potentially interesting year.

Written by:
Timothy Griffen, Director, Portfolio Manager/Analyst

EMERGING MARKETS EQUITY

Strong Fundamentals

The calendar year 2009 was very volatile for emerging markets, following a period—the last two quarters of 2008—where they had underperformed their developed counterparts for a couple of reasons. First, many investors had significant profits in emerging markets and were eager to realize them. Second, many investors recalled what happened in the 1980s and 1990s, when emerging markets underperformed the developed world in down movements.

Since bottoming in February and March of 2009, emerging markets have done extremely well, substantially outperforming the developed world. There are multiple drivers for this: the fundamentals in the developing world today are very good; their financial systems are not overleveraged; and consumers in many parts of the emerging world have a greater ability to spend in comparison to what is happening in the industrialized world.

The most critical economy in the world today, China, is demanding large amounts of commodities and basic manufactured goods, many of which are being sourced from other emerging countries. With people streaming from its rural areas to its cities, we believe that China, because of its need to employ those individuals, must continue growing. To avoid social unrest, enough jobs will have to be provided; we foresee this trend continuing for the next 10 years.

Compared to 10 years ago, when marginal demand came from the developed world, today there is a larger component of domestic consumer demand in emerging markets. Indeed, we believe that even export-oriented countries, like China, will have to depend to a greater degree on domestic consumption.

Currently, our strategy is positioned to benefit both from consumer and corporate/government spending in emerging markets, as we believe all these players are in reasonably good shape and will likely do well over the next five years. Consumers have more money than they have had for a long period of time; employment rates are relatively high;

governments have been helped by larger tax revenues; and corporations have generally had good profits over the course of the last six or seven years.

From a sector perspective, we have found less relative value recently in economy-sensitive areas, such as energy and materials, and more value in certain defensive areas. Therefore, we have allocated more capital to the telecom services and consumer sectors, and sold stocks in energy and materials.

From a country perspective, we continue to hold large exposures to Brazil, Mexico, Indonesia, Egypt, Turkey, Russia—for the first time we have larger-than-index exposure to Russia—and South Africa. Recently, we have trimmed some of our exposure in Indonesia and in Russia, because of upward price movements, but our emphasis is still there. For the last three years, we have found relatively little value in Chinese public equities. We do not have a large exposure in Taiwan; stocks are not terribly expensive there, but profitability is not high. We do not have a high exposure in Eastern Europe, either, particularly in Poland, Hungary, and the Czech Republic, where we still see expensive valuations. Chile is also a very expensive market, and we have no exposure there.

We remain optimistic over the long term. We believe that today, the fundamentals for the emerging markets equity asset class are as good as they have been at any time since the 1970s—and in our opinion we are in a period very similar to the 1970s. There is an industrial revolution taking place, and we believe we are going to see sustained demand for commodities and basic manufactured goods that will have to be sourced particularly from emerging markets.

Therefore, our outlook is optimistic over a three- to five-year term. However, we believe that this optimism must be tempered by the enormous rise we have seen in emerging markets equities since February 2009. As these markets do not tend to move in a linear fashion, we believe that investors should not be aggressive on a one-year view, and we are neutral over this shorter time period.

Written by:
James Donald, Managing Director, Portfolio Manager/Analyst

NOTES:

1 Source: U.S. Federal Reserve, U.S. Federal Housing Finance Agency, U.S. Treasury Department

2 Source: Bloomberg

3 Source: Bureau of Economic Analysis

4 Source: U.S. Federal Reserve, Bloomberg, U.S. Treasury Department, Social Security Administration

5 Refer to Lazard's Investment Focus paper "A Different Kind of Leverage," 5 January 2010, available at http://www.lazardnet.com/lam/us/literature_research.shtml

6 Source: Commercial Mortgage Alert

7 Source: Bloomberg

8 Source: U.S. Federal Reserve

9 Source: Bureau of Economic Analysis

10 Source: U.S. Census Bureau

11 Source: Bureau of Labor Statistics

Published on 12 January 2010.

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